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Supreme Court of the United States

OCTOBER TERM, A. D. 1940.

No. 691

CHICAGO AND NORTH WESTERN RAILWAY COMPANY and CHARLES M. THOMSON, Trustee of the Property of Chicago and North Western Railway Company,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI.

To United States Circuit Court of Appeals For the Seventh Circuit.

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Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI.

To United States Circuit Court of Appeals For the Seventh Circuit.

TO THE HONORABLE CHIEF JUSTICE AND ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

Your petitioners Chicago and North Western Railway Company and Charles M. Thomson, Trustee of the property of Chicago and North Western Railway Company, respect-

fully pray that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Seventh Circuit, entered on July 12, 1940 in a cause numbered and entitled on its Docket No. 7155, Chicago and North Western Railway Company and Charles M. Thomson, Trustee of the property of Chicago and North Western Railway Company, Petitioners vs. Commissioner of Internal Revenue, Respondent, affirming the decision of the United States Board of Tax Appeals. Petition for rehearing was denied October 18, 1940.

SUMMARY STATEMENT OF MATTER INVOLVED.

This proceeding is an income tax case involving the taxable years 1927 and 1928. The question is whether any deductions whatever may be taken for depreciation on five large elevators and three coal docks (all under lease to third parties for non-carrier purposes), and the taxpayer's[1] former office building in the business district of Chicago. The Commissioner allowed the deduction in the case of the office building (Record, pp. 26, 35, 40, 52), but not for the elevator and docks. He determined deficiencies to be due for each of the years 1927 and 1928, and on December 22, 1931 mailed the usual deficiency letter to the taxpayer (Record, p. 22). On February 5, 1932, the taxpayer filed a petition with the Board of Tax Appeals in which, among other things, error was predicated on the Commissioner's failure to allow any deduction for depreciation for the

[1] Since the filing of the petition with the Board of Tax Appeals, the Chicago and North Western Ry. Co., the original petitioner, applied for reorganization under Section 77 of the Bankruptcy Act as amended. The petitioner, Charles M. Thomson, as Trustee of the Railway Company's property, was added as a party by appropriate order of the Board. In this petition this Railway Company and the Trustee, when not referred to as "petitioners" will be referred to under the common designation of "taxpayer."

elevators and docks (Record, pp. 8, 10, 19). The answer was the usual general denial (Record, pp. 56-59, inclusive). The cause remained pending and inactive on the Board's docket for about five years, during which time the parties succeeded in disposing by agreement[1] of all issues except this one of depreciation (and one other which is discussed in the opinion of the Court below, but not involved in the present application). On October 4, 1937, an amendment to the petition somewhat amplifying the allegations of the petition and claiming an obsolesence deduction was filed (Record, p. 63). The same month and just before the trial the Commissioner filed an amended answer (Record, pp. 64-66). In it he repudiated the allowance for depreciation on the office building, and, alleging that he had erred in so doing, asked for affirmative relief. The Board of Tax Appeals, upon the supposed authority of its own prior decision in *Central R. R. of New Jersey* v. *Commissioner,* 35 B.T.A. 501, upheld the Commissioner (Record, pp. 777, ff.) 39 B.T.A. 661. The Circuit Court of Appeals for the Seventh Circuit affirmed the Board (Record, p. 848) 114 Fed. (2d) 882. This petition is to obtain a review of that decision.

It is not disputed that the elevators, docks and office building were and are subject to depreciation. Nor is there any dispute over the amount of depreciation allowable, if the taxpayer is entitled to any deduction[2] (except that the parties are in dispute over the amount to be allowed for obsolescence;[3] but the ground upon which both tribunals

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[1] See Record pp. 7-74, inclusive, for stipulations.

[2] Record, pp. 99, 182-184, 403, 497 (Exhibit 20), 593 (Exhibit 24).

[3] And, to a minor degree, the service life of concrete structures. The government's expert conceded a maximum of 50 years (Record, p. 403). What is the proper estimate is unimportant so far as the present application is concerned.

below decided the case makes it unnecessary to discuss this point). The Commissioner's sole defense to the taxpayer's claim with respect to the elevators and docks and his sole ground for repudiating his former action as to the office building are that the taxpayer, like most railroads, has, with respect to its roadway assets, used the so-called "retirement method" of accounting, under which, in general, repairs, renewals and retirements, unreduced by past accrued depreciation, have been charged to expense, but no depreciation has been charged under that name. This, in general, was the ground of the Board's decision in *Central R. R. of New Jersey* v. *Commissioner*, 35 B. T. A. 501, a case in which depreciation deductions were claimed for roadway assets by a railroad taxpayer using in its books the "retirement method" with respect to such assets,[1] but in which the taxpayer's claimed deductions failed to reflect the elimination of improper duplications. Unlike the situation in this *Central R. R. of New Jersey* case, the present taxpayer's computation of the deductions claimed

[1] In the *Central R. R. of New Jersey* case, the taxpayer, on its books, made conventional depreciation charges in the case of one large facility, the Newark Bay drawbridge. The Commissioner allowed this deduction, which thus "conformed with the petitioner's books of account" (35 B. T. A. 501 at page 502). It must therefore follow that if the present taxpayer had done the same thing the same deduction would have been allowed, although in that case all roadway retirement and other charges would have been the same and the mathematical result would have been what the taxpayer is here claiming. This would make the right to the deduction depend upon a mere bookkeeping entry, in the face of the rule laid down in *Doyle* v. *Mitchell Bros.*, 247 U. S. 179, 38 S. Ct. 467, 62 L. Ed. 1054, where this Court said that books "are not more than evidential, being neither indispensable nor conclusive" and that "the decision must rest upon the actual facts."

for elevator and dock depreciation reflects countercharges to avoid duplications. The evidence tends without substantial contradiction[1] to establish the fact that the amounts of depreciation claimed have been conservatively computed so as to avoid duplications and that all or substantially all such offsetting items are capable of ascertainment and have been properly reflected (Barnes' testimony, Record, pp. 188, 215-218, 234; Exhibits 20 and 24, pp. 497, ff., 593, ff.).

Notwithstanding the fact that the elevators and docks (improperly included by the taxpayer in the taxable years in its roadway property account) were not true roadway property but were under lease to third parties,[2] that they are few in number and each disproportionately large in relation to the multitude of items going to make up the operating property of a railroad, that in the computation of the claimed deduction duplications have been taken into account and eliminated, and that, in the case of the office building he himself earlier had recognized and applied the theory urged herein by taxpayer, the Commissioner contends that with respect to these assets no deduction what-

[1] Findings to this effect based on testimony largely uncontradicted were requested (Record, pp. 743, 744) but the Board ignored the subject. The Court's opinion contains a quotation from the *Central R. R. of New Jersey* case (Record, p. 854) on the subject of possible improper duplications, but ignores the important testimony in the present record negativing the existence of such duplications.

[2] The South Chicago elevator is located on a different railroad, the Indiana Harbor Belt (Record, p. 475, Exhibit 13), whose switching charges are absorbed by the North Western, just as in the case of movements to industries on switching lines (Record, pp. 167, 168). The Interstate Commerce Commission's valuation report (see Record, p. 607, Exhibit 49) treats the elevator and dock properties then in existence as non-carrier property. (See also Record, p. 267).

ever was or is allowable currently for depreciation. He has also in the present case seemingly recognized the corollary that upon the sale or other disposition of one or more of them a deduction may be taken of the entire "basis," unreduced by past depreciation, notwithstanding certain otherwise mandatory statutes hereinafter referred to, and a prior decision of this Court in favor of the Government (*U. S.* v. *Ludey*, 274 U. S. 295, 47 S. Ct. 608, 71 L. Ed. 1054). It so happens that his present theory operates in this case in his favor; but in many situations (including some affecting the present taxpayer) the interests of the parties are reversed. The present record shows that where this has been the case he has in the past taken the opposite view. At the present time he is now, in other litigation pending in the Court of Claims (mentioned below, p. 17), taking a position difficult, if not impossible, to reconcile with his theory in the present case.

In 1921 the South Chicago elevator (which alone accounts for well over half of the claimed deduction) was partly destroyed by an explosion (Record, pp. 87, 90). It was rebuilt in 1921 and 1922. Of the rebuilding cost, more than two million dollars was expended in 1922 and charged as an expense in the taxpayer's accounts (Record, p. 219). The elevator represented a capital cost of about four million dollars (Exhibit 20, Record pp. 497, ff.). In his final determination of the 1921 and 1922 tax liability the Commissioner insisted on treating this 1922 rehabilitation expense item in a manner inconsistent with his position in the present case[1] (Exhibit 39, Record pp. 647, ff.). This

[1] He disallowed the 1922 expense charge and transferred the amount to 1921, on the ground that the former was a capital item, and the loss, if allowable at all, was one sustained in 1921. In the latter year the taxpayer had a deficit, and so lost the benefit of the deduction. Under his theory in the present case, and that of the Board and Court below, the 1922 deduction should have been left undisturbed.

operated to the taxpayer's disadvantage (*Ibid;* also Record, pp. 405-6).

Of greater significance is the history of his treatment of the office building. In 1930 it seemed probable that the building would be sold. This occasioned a consideration of possible tax consequences. In view of the statutory provisions requiring reduction of the "basis" by past depreciation, and the then recently decided *Ludey* case (274 U. S. 295, 47 S. Ct. 608, 71 L. Ed. 1050, *supra*), which dealing with a situation that arose before these provisions were written into the statutes reached the same result, the taxpayer at that time had reason to suppose that the Commissioner would, in case the sale were consummated, compel such reduction of the "basis" notwithstanding the prior use of the "accounting method" relied on by him in the present proceeding (Record, p. 285). The taxpayer brought this matter to the Commissioner's attention, suggesting that the method of charging retirements, undepreciated (notwithstanding seemingly contrary statutory requirements and the seemingly contrary holding in the *Ludey* case), had an apparent justification, in the case of numerous regular routine requirements of a multitude of relatively minor roadway items, as a reflection under the law of averages of the "reasonable allowance for exhaustion, wear and tear" allowable by the statute,[1] but that this theory was open to serious question when applied to a retirement charge against a single year's income of a disproportion-

[1] Compare *Southern Ry Co.* v. *Commissioner*, 74 Fed. (2d) 887, cited and quoted from by the Court below (Record, p. 853), in which the question related to the treatment for tax purposes of the settlements for undermaintenance during Federal control. Also compare *U. S. Industrial Alcohol Co.* v. *Commissioner*, 42 B. T. A. —, decided November 28, 1940, which among other things seemingly recognizes the distinction between such items and "large nonfungible items of plant such as buildings and machinery" (*supra*, p. 19, footnote).

ately large amount representing the basis, undepreciated, of an individual item of the magnitude of an office building in the Chicago "loop" district (*Ibid*). The taxpayer therefore requested that for the taxable years then open the Commissioner restate its tax liability by reflecting in the computation of such liability a deduction representing a reasonable allowance for depreciation on the office building, and at the same time indicated a willingness to accept, upon consummation of the then proposed sale or upon any subsequent sale or other disposition of the building, a correlative reduction of the "basis" for determining gain or loss (Record, pp. 667, 669). Although this proposed adjustment appeared at the time to favor the Commissioner (since the "basis" would be reduced by all past depreciation but the taxpayer would receive the benefit of only the years then open) the taxpayer also favored it; for there would thus be salvaged at least some depreciation deductions which would otherwise probably be lost if the Commissioner should later, after the running of limitations as to the years then open, insist on literally applying the apparently mandatory statute and the rule laid down by this Court in the *Ludey* case. It being then apparently in his interest to approve this treatment of the office building, the Commissioner quite naturally did so, and for the years then open allowed the claimed depreciation deductions (Record, pp. 26, 35, 40, 52). The parties agreed on the "reasonable" amount so to be allowed, which was reflected in taxpayer's favor in the computations set out in the deficiency letter covering the years 1927 and 1928. This is the action which the Commissioner later, in his affirmative answer in this case, asserted was erroneous.

The elevators and docks, in addition to being, like the office building, large individual units, were and are under lease to third parties.[1] None is a part of the taxpayer's roadway property used in its business as common carrier.[2]

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[1] The leases are in evidence as exhibits 3-A to 10-D, inclusive. (Record, pp. 443, 462, inclusive).

[2] *Supra*, p. 5.

The taxpayer contended that the "retirement" theory was particularly open to question in their case, even if it were otherwise proper as to true roadway property. Under the theory urged herein by the Commissioner, and the decision of both the lower tribunals, if the four million dollar South Chicago elevator should be retired this entire amount, unreduced by past depreciation, would be chargeable against a single year's income. In such case the Commissioner might well, except as the decision in the present case would bar the way, contend that in view of the applicable statute and the *Ludey* case the use of this "basis", undepreciated, would seriously distort income, and therefore that it should be diminished by accumulated past depreciation, regardless of the taxpayer's failure currently to take or be allowed such deductions. The taxpayer has asked in this proceeding for the application of the corollary of the statutory rule and the theory of the *Ludey* case, namely, that it be allowed a deduction of such "reasonable allowance" for current depreciation as the evidence shows is allowable.

There is abundant testimony to support the conclusion that if the allowances herein claimed are allowed, the taxpayer will not have received an excessive allowance. No mention was made of this testimony by the Board or the Court below, both of which decided the case on the narrow ground that the "method of accounting" precluded taxpayer from being allowed the claimed deductions. In the case of the office building, although the Commissioner had the burden of proof to show he had allowed an excessive deduction he introduced no evidence whatever beyond a stipulation setting out the "method of accounting." Notwithstanding the absence of any evidence other than this stipulation, the Board and the Court below upheld the Commissioner. The opinion makes no mention of the fact that as to the office building it was the Commissioner who had the burden of proof, and mistakenly says (Record, p. 848) that the taxpayer contended it was entitled "as a

matter of law to have the depreciation allowance computed by the 'straight line' method." The exact reverse is the case; for the Commissioner to sustain his burden of proof relied on no more evidence than the "method of accounting" and his contention that this as a matter of law, without more, established his case. In the petition for rehearing this demonstrable error in the opinion was specifically called to the Court's attention (Record, pp. 861-863); but no correction was made. The actual decision upon the record is that as a matter of law a taxpayer using the retirement method is not entitled to show that charges representing depreciation in fact understate what is a reasonable allowance therefor. Thus all factual inquiry is precluded; and it follows, of course, that the same logic must, under all circumstances involving taxpayers thus employing the "retirement method", preclude the Commissioner from ever reducing the "basis" upon the sale or other disposition of any such asset, however large and however much the income for the year of retirement may be distorted unless the "basis" is so reduced.

Jurisdiction.

This being an application for a review of a final judgment of the Circuit Court of Appeals for the Seventh Circuit, the jurisdiction of this Court is sustained by Section 240 of the Judicial Code, as amended (U. S. Code, Title 28, Section 347), and by Section 1141 of the Internal Revenue Code (U. S. Code, Title 26, Section 1141). The Circuit Court of Appeals had jurisdiction under the second of these sections, namely Section 1141.

The judgment of the Circuit Court of Appeals was entered July 12, 1940 (Record, p. 860). Timely petition for rehearing was filed (Record, p. 861). Said petition was denied on October 18, 1940 (Record, p. 867).

Cases believed to sustain the jurisdiction are:

Old Colony Trust Co. v. *Commissioner,* 279 U. S. 716, 49 S. Ct. 499, 73 L. Ed. 918;

Magnum Import Co. v. *Coty,* 262 U. S. 159, 43 S. Ct. 531, 67 L. Ed. 922;

Columbus Watch Co. v. *Robbins,* 148 U. S. 266, 13 S. Ct. 594, 37 L. Ed. 445;

Smith v. *Wilson,* 273 U. S. 388, 47 S. Ct. 385, 71 L. Ed. 699.

Questions Presented.

The questions presented are whether use by a railroad company of the so-called "retirement method of accounting," in connection with roadway property accounts, without more:

(1) in all cases precludes a factual determination, fully compensating for possible duplications, of what in fact, apart from questions of accounting, is a reasonable depreciation allowance for disproportionately large individual items of leased property not actually used in the taxpayer's common carrier operations;

(2) is sufficient to maintain the Commissioner's burden of proof (as to an affirmative issue) with no showing by him that in fact the depreciation allowed by him was excessive;

(3) justifies or permits the disregard of the statutory command in the correlative situation involving the effect upon the "basis" of past depreciation (when large nonfungible individual units of property (especially property non-carrier in fact which is under lease) are retired or disposed of; and

(4) in such correlative situation justifies or permits a decision otherwise in flat contradiction of the rule laid down by this Court in *United States* v. *Ludey,* 274 U. S. 295, 47 S. Ct. 608, 71 L. Ed. 1054.

Reasons Relied On for the Allowance of the Writ.

Petitioners respectfully suggest the following reasons for the allowance of the writ herein prayed for:

1. The decision of the Circuit Court of Appeals in the present case is in conflict with the principle followed by the Eighth Circuit in *Northern Pacific* v. *Helvering,* 83 Fed. (2d) 508, 105 Fed. (2d) 730, in which the Circuit Court of Appeals for the Eighth Circuit, because of evidence in the record tending to sustain a conclusion contrary to what was shown on the taxpayer's books, upheld the taxpayer's contention that the credits against operating expenses of the cost of company transportation of men and materials should, for tax purposes, be taken at sums different from and less than certain Commission approved arbitrary percentages regularly used on the books of account. The court thus permitted greater deductions for operating expenses than those shown in the books of account. The books were treated as evidentiary only, and although *prima facie* evidence against the taxpayer, subject to explanation and rebuttal. A Board decision against the taxpayer (30 B. T. A. 1464) on the supposed authority of the Eighth Circuit decision in *Great Northern Ry.* v. *Commissioner,* 40 Fed. (2d) 372, which involved the same credit but in which the evidence was insufficient to contradict the books, was reversed and remanded (83 Fed. [2d] 508), the Court distinguishing its own prior decision in the *Great Northern* case upon the ground that, unlike that case, evidence had been introduced in the *Northern Pacific* case which if believed would sustain a factual determination contrary to the book entries.[1] The Board's decision upon remand, find-

[1] This is the same distinction which exists between the *Central R. R. of New Jersey* case, 35 B. T. A. 501, and the case at bar.

ing the facts in favor of the taxpayer (35 B. T. A. 1237), was upheld on the Commissioner's appeal (105 Fed. [2d] 730).

2. The Circuit Court of Appeals has decided the present case contrary to two applicable decisions of this Court:

(*a*) *United States* v. *Ludey*, 274 U. S. 295, 47 S. Ct. 608, 71 L. Ed. 1054, in which this Court, upholding the Commissioner of Internal Revenue, held that the "basis" for determining gain or loss must be reduced by accumulated past depreciation and depletion, whether or not the taxpayer currently has had the benefit of depreciation or depletion deductions in prior years; and

(*b*) *Helvering* v. *Union Pacific R. R.*, 293 U. S. 282, 55 S. Ct. 165, 79 L. Ed. 363, which expressly (at the taxpayer's instance) upheld the departure, for tax purposes, from past consistent accounting practice[1] in the case of discount and expense suffered at the time of the issuance of corporate bonds.

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[1] In the *Union Pacific* case, notwithstanding different treatment on the books of accounts, this Court approved the amortization of such discount and expense, and the deduction in the taxable year of the amortized amount thereof applicable to such year. This Court, in the same case and in support of its conclusion referred to the "analogies of depreciation deductions", which this Court termed "persuasive." The Board's decision in *Chicago, Rock Island and Pacific Ry.* v. *Commissioner*, 13 B. T. A. 988, in which such entries had been very numerous, was expressly affirmed. There, long before the incidence of the income tax laws the taxpayer had regularly followed a different "method of accounting" for discount suffered on sales of new bond flotations. (See 13 B. T. A. 988 at pages 1010 to 1012). Notwithstanding, the taxpayer was held entitled to use the amortization method. The decision below of the Circuit Court of Appeals in the instant case is in conflict with the fundamental principle upon the basis of which this Court decided the *Union Pacific* case.

3. The Circuit Court of Appeals decided this case in conflict with applicable statutory provisions adopted subsequent to this Court's decision in the *Ludey* case. These provisions (set out in an appendix to this petition, along with other pertinent statutory provisions) have written the philosophy of that decision into the Revenue Acts themselves. Revenue Act of 1926, Section 202(b)(2), (44 Stats. at Large 12); Revenue Act of 1928, Section 111(b)(2), (45 Stats. at Large 815). Corresponding provisions have been incorporated in the later Revenue Laws, including the one now in effect.

4. The Circuit Court of Appeals has misconceived this Court's decision in the *Ludey* case, 274 U. S. 295, 47 S. Ct. 608, 71 L. Ed. 1054. Of that decision the Court below said (Record, p. 854):

> "As we read the opinion in that case, the Supreme Court reversed a decision of the Court of Claims for the reason that to permit a taxpayer to deduct annual depreciation charges from gross income to determine the taxable income of the tax year and then to permit him to compute loss on a sale on the basis of the undiminished original cost of the asset would amount to permitting a double deduction for the loss of the same capital asset. The decision does not pass upon the validity of different methods of determining a 'reasonable allowance' for depreciation. The substance of the decision is that Congress did not intend a double deduction."

This conception of the *Ludey* case is not in accord with what was actually decided by this Court, nor with the statement in this Court's opinion that the compulsory reduction of the "basis" is "not dependent upon the amount claimed in earlier years", so that "if in any year the taxpayer has failed to claim, or has been denied, the amount to which he was entitled rectification of the error must be sought through a review of the action of the Bureau for that year."

5. This case involves important questions of Federal law which have not been but should be settled by this Court:

(*a*) Whether the application of the statutory provision that a taxpayer's net income be computed "in accordance with the method of accounting regularly employed in keeping the books of such taxpayer" (Section 212[b], Revenue Act of 1926, 44 Stats. at Large 23; Section 41, Revenue Act of 1928 45 Stats. at Large 805) is limited to alternative methods of accounting expressly or by necessary implication permitted under the law[1] or requires controlling effect to be given any "method of accounting" even if contrary to other express statutory provisions.

(*b*) Whether the same statutory provision that net income be computed in accordance with the taxpayer's "method of accounting" overrides or renders inapplicable the section dealing with depreciation (Revenue Act of 1926 Section 214[a][8], 44 Stat. at Large 27; Revenue Act of 1928, Section 23[k], 45 Stat. at Large 800) and that providing for the compulsory reduction, by past depreciation, of the "basis" for determining gain or loss upon sale or other disposition of property (Revenue Act of 1926, Section 202[b][2], 44 Stat. at Large 12; Revenue Act of 1928, Section 111[b][2], 45 Stat. at Large 815).

(*c*) Whether when large "non-fungible"[2] individual units of railroad property are retired,[3] (including such units when retired in the course of a railroad's abandonment program) the same statute and the use of the "retirement method of accounting" will, as a matter of law, prevent reduction of the "basis" by past accumulated depreciation.

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[1] Of which the most usual example is the alternative of the "cash" and "accrual" methods of accounting, compare *Helvering* v. *Union Pacific,* 293 U. S. 282, 55 S. Ct. 165, 74 L. Ed. 363.

[2] Compare *U. S. Industrial Alcohol Co.* v. *Commissioner,* 42 B. T. A. —, decided November 28, 1940, (infra, p. 19, footnote).

[3] The Commissioner's main witness (on this branch of the case), Rogers, a Government engineer and expert,

These are questions of general importance in the administration of the Federal Revenue Laws, and may in the near future become more important. The physical life of many large railroad structures is approaching its end; and recent economic trends have tended to encourage in the interest of economy the abandonment of substantial amounts of railroad mileage. What is the proper treatment, for tax purposes, of retirements of such large structures presents an important question peculiarly appropriate for the determination of this Court. Although the ele-

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admitted on cross-examination (Record, p. 387) that he "would absolutely draw a distinction between a terminal company, and a Class I railroad," and said further that in the case of a large structure "manifestly, on a very small railroad, if they only have a very expensive structure and that expensive structure comprised a large percentage of their entire investment, if that structure was to go out that would distort the income" (*Ibid*). He thought the problem "comes down to a question of degree, to that extent" (Record, p. 388). Yet the Commissioner in a recent case involving a terminal company's claim for a depreciation deduction on a large passenger station comprising one-third of its assets refused to apply his expert witness' theory. The Board, in a memorandum opinion rendered October 24, 1940 which made no mention of the suggested distinction, upheld the Commissioner on the authority of the case at bar and the *Central R. R. of New Jersey* case. *St. Paul Union Depot* v. *Commissioner,* B. T. A. Docket 93538, not reported but available through the Commerce Clearing House Board of Tax Appeals Service as Decision 11361-B (also abstracted, in Commerce Clearing House 1940 Federal Tax Service, paragraph 7561-B). If this case is appealed it will be to the Eighth Circuit. The decision is in flat contradiction of the statute, not in accord with the *Ludey* case (274 U. S. 295, 47 S. Ct. 608, 71 L. Ed. 1054), and clearly contrary to the principle which this court followed in *Helvering* v. *Union Pacific,* 293 U. S. 282, 55 S. Ct. 165, 74 L. Ed. 363.

vator and dock properties involved in the present case were at one time erroneously included in the roadway property accounts, they (but not the office building) were not and are not true roadway structures; but as the Court below and the Board ignored this distinction the decision is an authority against the application of the *Ludey* philosophy to retirements of large railroad owned structures, and if followed in other situations will prevent the reduction of the "basis" by past depreciation in all cases of structures carried in roadway account. However, the decision, not being by this Court, is not controlling; and as a denial of an application for a writ of *certiorari* is not tantamount to an affirmance of the decision below (*Hamilton Shoe Co.* v. *Wolf Bros.*, 240 U. S. 251, 36 S. Ct. 269, 60 L. Ed. 629) and the Commissioner's interest may in some other proceeding be to urge the opposite contention, the law on the subject must continue uncertain until this Court has spoken in some other case. This creates a situation unsatisfactory to both the Government and railroad taxpayers. A review and decision by this Court of the present case, therefore, is desirable in the general interest.

6. The Circuit Court of Appeals departed from the accepted and usual course of judicial proceedings, and sanctioned such departure by the Board of Tax Appeals, by permitting a party having the burden of proof (the Commissioner) to prevail without introducing the evidence necessary to sustain that burden; for upon the affirmative issue relating to the office building no evidence was introduced to show that a reasonable depreciation allowance was in fact less than what he had already voluntarily allowed.

7. A case is now pending in the Court of Claims involving the taxable year 1930 in which the present taxpayer is plaintiff (*Thomson, Trustee of the property of Chicago and North Western Ry. Co.* v. *United States*, Court

of Claims Docket No. 43624)[1] in which one question raised by the pleadings is whether upon retirement of roadway assets the Commissioner (contrary to the theory upon which the instant case was decided by the Court below) was correct in reducing the "basis" of assets owned on March 1, 1913, by depreciation considered by him to have been sustained prior to that date, although the "method of accounting" was that relied on by the Commissioner in the instant case. This suggests that the Commissioner, well aware of the importance from the Government's standpoint of the treatment of railroad retirements for tax purposes, now favors a "hybrid" method, under which the "basis" of assets owned on March 1, 1913, would on retirement be reduced by depreciation prior to that date, while no reduction would be made for depreciation sustained thereafter. He would thus in part apply the *Ludey* philosophy, and give effect to part (but not all) of the statutory provisions applicable in such cases, even though to do so is not in harmony with his "method of accounting" theory. A "hybrid" method no more illogical, except that it was sought by the taxpayer, was condemned by the Board in its decision in *Central Railroad of New Jersey* v. *Commissioner*, 35 B. T. A. 501,[2] the precedent said by the Board to rule the present case. A decision in favor of the taxpayer by the Court of Claims, in the case now pending before it, would

[1] We assume that this is a proper subject of judicial notice as a public record. *Davis* v. *Farmers Cooperative Assn.*, 262 U. S. 312, 43 S. Ct. 556, 67 L. Ed. 996; *C. & N. W. Ry.* v. *Railroad Comm. of Wisconsin*, 156 Wis. 47, 145 N. W. 216.

[2] The taxpayer there sought to deduct depreciation charges for assets acquired since March 1, 1913 only, without any restatement of its accounts from 1913 to the taxable year to eliminate duplications, and as to other assets it sought to use the "retirement method." This is virtually the converse of the Commissioner's position in the pending Court of Claims case.

be in harmony with lower tribunals' decision herein. (This, for reasons not here material, might still be true even if the decision below had been in favor of the taxpayer.[1]) On

[1] In *U. S. Industrial Alcohol Co.* v. *Commissioner*, 42 B. T. A. —, decided by the Board of Tax Appeals November 28, 1940, one issue was whether the taxpayer might have a deduction for drums used as containers. No depreciation as such was charged on the books but drums retired were charged off without reduction for past depreciation. On the authority of the decisions below in the present case, and of the *Central R. R. of New Jersey* case, the claimed deductions were denied; but in the opinion the Board used this language:

> "Petitioner's drum property consisted of a large number of units which were for the most part treated as completely interchangeable. They had a uniform estimated useful life but were purchased in substantial quantities in each of a number of years. It follows that if such annual purchases became useless at the end of a constant period, which is the assumption upon which depreciation is claimed, the cost to the enterprise of the ultimate destruction of their value would become a reasonably standard annual expense. * * * It would not forecast an extraordinary and nonrecurring item of loss in any given year so as to distort the income of that year as is to be expected with *large nonfungible items of plant such as buildings or machinery.*" (Italics ours.)

Yet in the present case both tribunals below ignored the obvious distinction between the numerous relatively small items of roadway property and "large nonfungible items" such as those here involved. The logic of the quoted language would seemingly permit and require current depreciation charges in the case of the "large nonfungible" elevator, dock and office building items and the application of the *Ludey* philosophy to them upon retirement, and yet also permit, in the case of retirements of items such as rail, ties, fastenings, numerous bridges and culverts, minor structures, and the multitude of items comprising roadway property (compare *Southern Ry.* v. *Commissioner*, 74 Fed. [2d] 887, *supra*, p. 7), the

the other hand, a decision by the Court of Claims upholding the "hybrid" method thus proposed by the Government would be very difficult to reconcile with the theory upon which the Board and the Circuit Court of Appeals decided the present case. The possibility is therefore presented that unless there is a review by this Court the taxpayer, although entitled to prevail in at least one of these cases, might be defeated in both. In that case at least one of the decisions would be erroneous. On the other hand, because of the precedent of the decision of the Seventh Circuit herein, there is the distinct possibility of the Government's defeat in the Court of Claims. And if successful in the Court of Claims case the Commissioner may conceivably not be content with his "hybrid" treatment of these items and later insist on full application of the *Ludey* principle and of all, not only part, of the applicable statutes, so that upon future retirements the basis of such structures will be reduced by all instead of only a part of the past depreciation; for the Commissioner is of course not estopped because of any past error of law. These possibilities and the importance of the question involved make this case one appropriate for review and determination by this Court.

CONCLUSION.

WHEREFORE, your petitioners respectfully pray that a writ of *certiorari* be issued out of and under the seal of this Honorable Court, directed to the United States Circuit Court of Appeals for the Seventh Circuit, commanding that Court to certify and send to this Court for its review and determination, on a day certain to be therein

---

deduction in harmony with the "accounting method" of the entire ledger value, or other basis, unreduced by past depreciation. But, however that may be, the decisions of the court below and the Board ignore this distinction which has thus seemingly, albeit belatedly, been recognized by the Board itself in this *Industrial Alcohol* decision.

named, a full and complete transcript of the record and all proceedings in this case numbered and entitled on its docket as Number 7155, *Chicago and North Western Railway Company and Charles M. Thomson, Trustee of the property of Chicago and North Western Railway Company* v. *Commissioner of Internal Revenue*, and that the decision of the United States Board of Tax Appeals and the judgment of the United States Circuit Court of Appeals for the Seventh Circuit be reversed by this Honorable Court, and that your petitioners may have such other and further relief in the premises as to this Court may seem proper.

Dated at Chicago, Illinois, December 10, 1940.

Respectfully submitted,

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APPENDIX

STATUTES INVOLVED.

1. Relating to jurisdiction:

Section 240, Judicial Code, as amended (U. S. Code, Title 28, Section 347).

(a) In any case, civil or criminal, in a circuit court of appeals, or in the Court of Appeals of the District of Columbia, it shall be competent for the Supreme Court of the United States, upon the petition of any party thereto, whether Government or other litigant, to require by certiorari, either before or after a judgment or decree by such lower court, that the cause be certified to the Supreme Court for determination by it with the same power and authority, and with like effect, as if the cause had been brought there by unrestricted writ of error or appeal.

* * * *

(c) No judgment or decree of a circuit court of appeals or of the Court of Appeals of the District of Columbia shall be subject to review by the Supreme Court otherwise than as provided in this section.

Section 1141, Internal Revenue Code (U. S. Code, Title 26, Section 1141).

COURTS OF REVIEW.

(a) JURISDICTION. The Circuit Court of Appeals and the United States Court of Appeals for the District of Columbia shall have exclusive jurisdiction to review the decisions of the Board, except as provided in section 239 of the Judicial Code, as amended, 43 Stat. 938 (U. S. C., Title 28, Sect. 346); and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in section 240 of the Judicial Code, as amended, 43 Stat. 938 (U. S. C., Title 28, Sect. 347).

(b) VENUE.

(1) IN GENERAL. Except as provided in paragraph 2, such decisions may be reviewed by the Circuit Court of Appeals for the circuit in which is located the collector's office to which was made the return of the tax in respect of which the liability arises or, if no return was made, then by the United States Court of Appeals for the District of Columbia.

(2) * * * *

(3) APPLICATION OF SUBSECTION. This subsection shall be applicable to all decisions of the Board rendered on and after May 10, 1934, and section 1002 of the Revenue Act of 1926, 44 Stat. 110, as in force prior to May 10, 1934, shall be applicable to such decisions rendered prior thereto, except that paragraph 2 of this subsection may be applied to any such decision rendered prior to May 10, 1934.

(c) POWERS.

(1) TO AFFIRM, MODIFY, OR REVERSE. Upon such review, such courts shall have power to affirm or, if the decision of the Board is not in accordance with law, to modify or to reverse the decision of the Board, with or without remanding the case for a rehearing, as justice may require. * * *

* * * *

2. Relating to deduction for depreciation:

Revenue Act of 1926, Section 214 (a) (8), 44 Stats. at Large 27, and Revenue Act of 1928, Section 23 (k), 45 Stats. at Large 800.

In computing net income there shall be allowed as deductions:

* * * *

A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence.

* * * *

3. Relating to adjustment for past depreciation of "basis" for determining gain or loss:

Revenue Act of 1926, Section 202 (b) (2), (44 Stats. at Large 12) and Revenue Act of 1928, Section 111 (b) (2), (45 Stats. at Large 815).

> The basis shall be diminished by the amount of the deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion which have since the acquisition of the property been allowable in respect of such property under this Act or prior income tax laws. * * * In addition, if the property was acquired before March 1, 1913, the basis (if other than the fair market value as of March 1, 1913) shall be diminished in the amount of exhaustion, wear and tear, obsolescence, and depletion actually sustained before such date.

4. Relating to accounting methods:

Revenue Act of 1926, Section 212 (b) (44 Stats. at Large 23), and Revenue Act of 1928, Section 41, (45 Stats. at Large 805).

> The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

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CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1940

No. 691

CHICAGO AND NORTH WESTERN RAILWAY COMPANY and CHARLES M. THOMSON, Trustee of the Property of Chicago and North Western Railway Company,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

REPLY TO RESPONDENT'S BRIEF IN OPPOSITION TO ALLOWANCE OF WRIT OF CERTIORARI

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NO DUPLICATED ITEMS

In the Government's brief in opposition, it is adroitly suggested (on pages 4 and 5) that if accorded the relief sought the taxpayer would benefit by double deductions. Reference is made (page 5) to the treatment of the large elevator rehabilitation items in 1921 and 1922. The inference is suggested that because of the deductions of $951,821.37 and $2,114,778.81, in 1921 and 1922, and the transfer of the latter amount by the Commissioner from 1922 to 1921, the taxpayer obtained an advantage that should preclude the relief now sought. The fact is, as the record abundantly demonstrates (for example, see Record p. 647, Exhibit

39), that the Commissioner's treatment of these items was inconsistent with his position in the present case and with the Government's argument, was contrary to the very method of accounting now relied on by him, and in addition considerably increased the taxes paid for 1921 and 1922. Moreover, these suggestions (on pages 4 and 5 of the Government's brief) ignore uncontradicted testimony that the calculations of the allowances claimed (Record pp. 497 ff., Exhibit 20) take full account of and reflect properly all counterbalancing items with respect to the leased elevators and docks, so that duplications have been eliminated.

In the case of the office building, the Commissioner himself had allowed depreciation, not only for 1927 and 1928, as the Government's brief states (pages 5 and 6), but for all years back to 1923 (Record pp. 647 ff., Exhibit 39), under the circumstances fully detailed in the record (pp. 285 ff.; p. 667, Exhibit 40; p. 669, Exhibit 41), at a time when that course appeared to be to the Commissioner's ultimate advantage. Presumably in the case of the office building, he took care of possible duplications when he made the allowance for all these years from 1923 to 1928. Though having the burden of proof as to this affirmative issue, he offered no proof to the contrary. The fact is that if the relief here sought is allowed, the taxpayer will have no advantage by way of improper duplications of deductions.

COMMISSIONER IN ALLOWING OFFICE BUILDING DEPRECIATION WAIVED HIS OWN REGULATION

The Government refers (on p. 7 of its brief) to the regulation [1] which provides that a taxpayer may change his method of accounting only by applying

[1] Regulations 69 and 74, Article 23.

for permission at least 30 days before the close of the taxable period, furnishing certain detailed information to the Commissioner. It is then said that "in view of the opportunities for eliminating entirely items of taxable income or for obtaining the same deduction twice, through a change of accounting methods, the foregoing regulations are reasonably calculated to safeguard the revenues". Before he allowed depreciation on the office building, the Commissioner presumably availed himself of his opportunity to prevent the taxpayer's "eliminating entirely items of taxable income" and "obtaining the same deduction twice". He did just what he would have done had application been made 30 days before the close of the taxable year. The time limit in his own regulations had, to be sure, not been complied with; but this was a mere administratively prescribed time limit of the Commissioner which he was at liberty to waive if he saw fit. At that time the waiver appeared to be favorable to the revenues. Yet, with no proof that he had erred in fact, and although he had the burden of proof, he was permitted by the tribunals below to obtain a reversal of his own former action, after the time had gone by within which he could make an administrative determination which the taxpayer, not he, would have the burden of upsetting. Plainly, if he had allowed this depreciation upon application by the taxpayer 30 days before the close of the taxable year, as expressly permitted by the Regulations, his action would have been unassailable by him after he issued his deficiency letter except for error in fact or fraud, in which case he, not the taxpayer, would have the burden of proof. Should the result be different merely because he waived his own administrative requirement?

One ground relied on for the allowance of the writ herein is that the tribunals below departed from the accepted and usual course of judicial proceedings by permitting a party having the burden of proof to prevail without introducing testimony necessary to sustain the burden. The Government's brief wholly ignores this important point. It cannot be that in a matter within the Commissioner's discretion his own action favorable to a taxpayer is wholly void merely because he himself has not insisted on strict compliance with a regulation promulgated by himself for his own administrative convenience. The Commissioner concededly may in his discretion, upon proper application and showing, permit a change of accounting methods. His action in the present case in retroactively allowing the office building depreciation cannot be wholly void merely because the permitted departure from the taxpayer's method of accounting was retroactive. At least with respect to the office building item the decisions below were plainly erroneous, even if the provision of the Regulations relied on sustains the result in the case of the other items.

NORTHERN PACIFIC CASE IN CONFLICT WITH DECISION BELOW

The Government asserts (brief, pp. 7-8), that the decision below is not in conflict with *Northern Pacific* v. *Helvering*, 83 F. (2d) 508 (C.C.A. 8th). It is stated (p. 8), that in that case "there was no controversy over the method of accounting employed." The fact is that in that case the taxpayer, although using "the average cost of the services if rendered to the public" as its method of accounting for the transportation costs there involved, claimed the right to employ a different method, the "out-of-pocket" method, for tax

purposes. The opinion makes it plain that there were these two "methods". The Board of Tax Appeals adopted the "average cost" standard. The court, after analyzing both methods, said it was "led to conclude that the proper measure for determining this transportation for construction cost is the 'out-of-pocket' method." Thereby it permitted a departure for tax purposes from the "method" employed by the taxpayer on its books and adopted by the Board. The decision below and the *Northern Pacific* case, *supra*, conflict; for in one case, the present one, the taxpayer was held bound as a matter of law by a "method of accounting" for which there is no affirmative statutory recognition, while in the *Northern Pacific* case the taxpayer was not compelled for tax purposes to follow the "method of accounting" it had itself used on its books.

GOVERNMENT'S CONTENTION IN COURT OF CLAIMS CASE INCONSISTENT WITH DECISION BELOW

The Government's brief (on pages 9 and 10) admits that in the case pending in the Court of Claims it seeks to treat retirement deductions as the petition states (on pages 17 to 20 of the petition herein). The inconsistency between the decisions below and the Government's position in this Court of Claims case is dismissed with the statement (brief p. 10) that "as to assets acquired prior to March 1, 1913, the same statute [1] requires that the basis be diminished by the amount of depreciation actually sustained before said date," and the further statement that "in accord with

[1] The section is not cited in the government's brief. Section 202 of the 1926 Act and Section 111 of the 1928 Act are obviously referred to.

this specific legislative requirement [1] the Government is contending in the Court of Claims case that the cost basis of assets acquired prior to March 1, 1913, must be depreciated down to that date in order to arrive at the fair market value as of March 1, 1913, the effective date of their income tax laws."

Yet earlier in its brief (on pages 6 and 7) the Government argues that "under the statute, petitioner is entitled to a 'reasonable allowance for the exhaustion, wear and tear of property' "; that either the straight line or the "retirement" method was proper; and (on page 4) that the taxpayer's income "was reflected clearly and with reasonable consistency by the use of this (retirement) method." Such reflection would, if true, have been equally true had no income tax law ever been passed. The Commissioner's case is bottomed on the statutory provision requiring "net income" to be "computed upon the basis of the taxpayer's annual accounting period" provided the method "clearly reflects the income." Retirement charges are admittedly deductible under the section of the law permitting deductions for depreciation, not the one relating to losses. Under the Government's theory herein and that of both opinions below, the section of the law relating to the determination of the "basis" for gain or loss is necessarily immaterial. The taxpayer's argument to the contrary was rejected below. Income is "reflected", so it is said, by the "retirement" method. If this is true, it is true without regard to March 1, 1913, or any other particular date. But under the Commissioner's admitted con-

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[1] The section is not cited in the government's brief. Section 202 of the 1926 Act and Section 111 of the 1928 Act are obviously referred to.

tention in the Court of Claims case (and evidently his policy in all similar cases) the depreciation allowance otherwise reasonable under the "retirement" method as reflecting income must be drastically reduced to reflect depreciation "sustained" prior to March 1, 1913. The deduction for depreciation if so reduced must necessarily become less than what otherwise in fact reasonably "reflects" income under the "retirement" method. This contention is contrary to the Government's theory in the present case and to the opinions of both tribunals below. If these opinions are right, the Commissioner is wrong in his contention in the Court of Claims case. If he is right in his contention in that case the statutory sections relating to the "basis" for gain or loss would, as the taxpayer argued herein, preclude retirement deductions, undepreciated, of such structures as are here involved, and as a corollary must entitle the taxpayer to current depreciation deductions. The excuse assigned in the Government's brief (p. 10) for the Commissioner's contention in the Court of Claims case is no more than an attempt to avoid the consequences of his own argument herein, and of the opinion below, in their bearing upon major problems of railroad roadway retirements. The inconsistency exists and cannot be thus lightly dismissed. At least there is sufficient basis for concluding that there is such inconsistency as to make this a proper case for a full review.

Respectfully submitted,

NELSON TROTTMAN,
Attorney for Petitioner.

WILLIAM T. FARICY,
of Counsel.

In the Supreme Court of the United States

OCTOBER TERM, 1940

No. 691

CHICAGO AND NORTH WESTERN RAILWAY COMPANY AND CHARLES M. THOMPSON, TRUSTEE OF THE PROPERTY OF CHICAGO AND NORTH WESTERN RAILWAY COMPANY, PETITIONERS

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 777–784) is reported in 39 B. T. A. 661. The opinion of the Circuit Court of Appeals (R. 848–859) is reported in 114 F. (2d) 882.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered July 12, 1940. (R. 860.) A petition for rehearing was denied October 18, 1940. (R.

867.) The petition for writ of certiorari was filed January 11, 1941. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether a railroad, which has consistently used the "retirement method" of depreciation accounting not only in its reports to the Interstate Commerce Commission, but also in its income tax returns, is entitled to have the "straight line" method of depreciation accounting applied retroactively as to certain structures.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are set forth in the Appendix, *infra,* pp. 11–17.

STATEMENT

This case involves income taxes for the years 1927 and 1928. The applicable findings of fact of the Board of Tax Appeals (R. 778–780) may be stated as follows:

The Chicago & North Western Railway Company (herein called petitioner) is a railroad corporation organized under the laws of Illinois, Wisconsin, and Michigan, and is engaged in the business of common carrier for hire, with principal office at Chicago, Illinois. Petitioner's system of accounts is in accordance with the accounting regulations of the Interstate Commerce Commission,

and its income tax returns are in accordance with its accounts. (R. 778.)

In 1927 and 1928, petitioner owned five grain elevators, three coal docks, and a building in the business district of Chicago, in which its general offices were located. Its largest elevator was built at South Chicago, Illinois, in 1915 and rebuilt after an explosion which partially wrecked it in 1921. (R. 779.) The elevators and docks were constructed of reinforced concrete; they comprised 68 separate structures and 1,510 units of machinery, built or installed at various times from 1874 to 1929. (R. 779.)[1]

Petitioner has consistently carried the elevators and docks in account No. 701, "Investment in Road and Equipment," as prescribed by the Interstate Commerce Commission, and it so carried its office building until 1936, when that asset was transferred to account No. 705, "Miscellaneous Physical Property." Petitioner has never set up accounts for exhaustion, wear and tear, and obsolescence in respect of assets carried in accounts Nos. 701 and 705, but has charged to expense all expenditures for repairs, maintenance, renewals, and replacements and for cost of all assets retired, of

[1] While the petitioner's total assets in 1927 exceeded a half billion dollars (R. 253), with structures having an asserted base then of $126,290,268 (R. 599), the aggregate value of the structures here involved, for which special treatment is asked, was less than $10,000,000 (R. 593).

whatever kind, undiminished by depreciation sustained in prior accounting periods, and it has claimed and been allowed these amounts as deductions in its income tax returns, including those for 1927 and 1928, and has never sought from the Commissioner of Internal Revenue nor been granted permission to change this method of reporting. On the same basis, it has prepared its annual reports to the Interstate Commerce Commission. (R. 779.)

Its practice in this respect, in accordance with Section 7 of the Interstate Commerce Commission's "Classification of Investment in Road and Equipment," is to charge to expense any expenditure for repairs or replacements if the expenditure amounts to less than half of the value of the property as restored. If the amount is half or more of the value of the property as restored, the original cost of the property is credited to the asset account and charged to expense, and the asset account is charged with the amount of the new expenditure plus the appraised value of the retained portions of the old facility. Expenditures of less than $500 were regularly charged to expense unless a complete unit of property was replaced. Petitioner's income was reflected clearly and with reasonable consistency by the use of this method. (R. 780.)

Petitioner's books do not disclose what amounts have been charged to expense on account of replacements costing less than half the value of the property renewed, and it cannot be determined

from the entries of amounts expended whether the repairs and replacements prolonged the asset's useful life. Charges on account of all retirements, whether made to operating expense, miscellaneous rent income, or profit and loss accounts, were deducted in petitioner's income tax returns for 1927 and 1928, as in other years. Neither the books nor the returns contained any figure of annual depreciation on any of petitioner's properties. Among replacement costs charged to expense and claimed as income tax deductions were $951,821.37 and $2,114,778.81 expended in 1921 and 1922, respectively, in rebuilding the South Chicago elevator after the explosion. The Commissioner disallowed the latter amount for 1922, but did allow it for 1921 as a deductible loss sustained in the year when the explosion occurred. Similarly, the estimated or original cost of parts of the Rialto elevator, destroyed by fire in 1933, was deducted for that year. (R. 780.)

Petitioner did not enter on its books or deduct on its tax returns any amount representing depreciation on its office building, which was constructed in 1905 at a cost of $1,344,325. It charged to expense all expenditures for repairs and replacements as permitted by the regulations of the Interstate Commerce Commission, and these amounts have been deducted on its tax returns and allowed. After a protest was filed by it, however, the Commissioner allowed a deduction of $26,826.50

on account of depreciation on the building for 1927 and 1928. (R. 780.)

The Board concluded that (R. 783) for the years in question, 1927 and 1928, the petitioner should be restricted to the use of the retirement method, and disallowed depreciation deductions for the office building as well as the grain elevators and docks.[2] The court below affirmed. (R. 860.)

ARGUMENT

The court below concluded that (R. 853) the petitioner, having elected through a long period of years, including the taxable years in question, to employ the retirement method for all of its property treated as a unit, can not now claim as a matter of right the privilege of retroactively applying a different method of accounting for depreciation in respect to certain items of property for certain taxable years. The decision is correct and, in the absence of any conflict of authority, the present petition should be denied.

Under the statute, petitioner is entitled to a "reasonable allowance for the exhaustion, wear and tear of property used in the trade or business * * *." Section 234 (a) (7) of the Revenue Act of 1926 and Section 23 (k) of the Rev-

[2] A major portion of the testimony and the exhibits in the voluminous record here presented has reference to applicable rates of depreciation and obsolescence if and when allowable. Since the Board ruled that the petitioner was not entitled to apply depreciation to the tax years here in question, it was not necessary to determine what rates would be applicable.

enue Act of 1928. For many years, petitioner had employed the "retirement" method of accounting rather than the "straight line" method in computing that allowance. Either method was proper, but since petitioner kept its books in accordance with the former method, it was bound to report its income upon that basis. Section 212 (b) of the 1926 Act and Section 41 of the 1928 Act, Appendix, *infra,* p. 11. A taxpayer may change his method of accounting only by applying for permission at least 30 days before the close of the taxable period, furnishing certain detailed information to the Commissioner. Article 23 of Regulations 69 and 74, Appendix, *infra,* pp. 12–17. In view of the opportunities for eliminating entirely items of taxable income or for obtaining the same deduction twice, through a change in accounting methods, the foregoing regulations are reasonably calculated to safeguard the revenues within the authority granted to the Commissioner under the statute. Admittedly, no such application for permission to change accounting methods was filed by the petitioner, and it is therefore not entitled to have its income computed under a different system of accounting.

1. As the first reason for granting the writ, the petitioner asserts (Pet. 12) that the decision below conflicts in principle with *Northern Pac. Ry. Co.* v. *Helvering,* 83 F. (2d) 508 (C. C. A. 8th). In that case, there was no controversy over the

method of accounting employed. The problem there was simply one of proof. It was conceded that the transportation expenses of men and material in connection with new construction should be deducted from maintenance and operating expenses as a capital item. As the court there stated (p. 509): "The controversy is over the amount of such transportation expense in each of these years." The question here is not merely one of determining whether book entries are controlling as to the amount of depreciation sustained, but a much broader one, i. e., whether a large railway system which has been enjoying the benefits of the retirement method of accounting for all of its holdings can now apply retroactively the straight line method of accounting for depreciation with respect to specified structures.

2. As a second reason for granting the writ, petitioner asserts that (Pet. 13) the decision below is contrary to two decisions of this Court: *United States* v. *Ludey,* 274 U. S. 295, and *Helvering* v. *Union Pacific Co.,* 293 U. S. 282. Neither of these decisions is in point.

The *Ludey* case involved the question of basis for computing gain upon sale, and more particularly, the extent to which adjustments should be made in basis on account of prior depletion or depreciation. The Court held that the basis was to be reduced, not by the full amount of depletion or depreciation actually sustained, as contended by the Government, but rather by the amount of

depletion or depreciation allowable in the earlier years. 274 U. S. at 303–304. The limited scope of the *Ludey* case is indicated in *Burnet* v. *Thompson Oil & G. Co.*, 283 U. S. 301, 306–307.

The *Union Pacific* case has an even less direct bearing. There the taxpayer corporation had issued bonds at a discount, and sought to amortize the bond discount, as well as issuance expenses, over the life of the issue. The Court held that since the corporation employed the accrual basis of accounting, such amortization was proper.

3. Reference by the petitioner (Pet. 17–20) to *Thomson, Trustee of the property of Chicago and North Western Ry. Co.* v. *United States,* now pending in the Court of Claims, wherein the Government is contending that the basis of railway assets owned on March 1, 1913, should be diminished by depreciation sustained prior to that date, furnishes no ground for the issuance of the writ here. It will be observed that in the Court of Claims case, the Government makes no contention that depreciation subsequent to March 1, 1913, must be likewise offset. Thus, the petitioner's apprehension that the Government would improperly apply the *Ludey* decision seems unwarranted. In line with the *Ludey* decision, Section 202 (b) (2) of the Revenue Act of 1926 (*infra,* p. 11), provides, in effect, that the basis of property acquired after March 1, 1913, shall be diminished by "allowable" depreciation. Since under the retirement method of accounting followed by the railroads, no depreciation

as such is allowable for the individual items, there is no authority for reducing the basis. However, as to assets acquired prior to March 1, 1913, the same statute requires that the basis be diminished by the amount of depreciation "actually sustained before such date." In accord with this specific legislative requirement, the Government is contending in the Court of Claims case that the cost basis of assets acquired prior to March 1, 1913, must be depreciated down to that date in order to arrive at the fair market value as of March 1, 1913, the effective date of the income tax laws.

CONCLUSION

The decision below is correct. There is no conflict of authority. The Government's position in the Court of Claims case is not inconsistent with the result herein. There is no occasion for further review, and the petition should therefore be denied.

Respectfully submitted.

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FEBRUARY, 1941.

APPENDIX

Revenue Act of 1926, c. 27, 44 Stat. 9:

SEC. 202. * * *

(b) In computing the amount of gain or loss under subdivision (a)—

* * * * *

(2) The basis shall be diminished by the amount of the deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion which have since the acquisition of the property been allowable in respect of such property under this Act or prior income tax laws; but in no case shall the amount of the diminution in respect of depletion exceed a depletion deduction computed without reference to discovery value or to paragraph (2) of subdivision (c) of section 204. In addition, if the property was acquired before March 1, 1913, the basis (if other than the fair market value as of March 1, 1913) shall be diminished in the amount of exhaustion, wear and tear, obsolescence, and depletion actually sustained before such date.

* * * * *

(Section 111 (b) (2) of the Revenue Act of 1928, c. 852, 45 Stat. 791, is to the same effect.)

SEC. 212. * * *

(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no

such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 200 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(Section 41 of the Revenue Act of 1928 is to the same effect.)

SEC. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * *

(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

* * * * *

(Section 23 (k) of the Revenue Act of 1928 is to the same effect.)

Treasury Regulations 69, promulgated under the Revenue Act of 1926:

ART. 23. *Bases of computation.*—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 200 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included

in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. (See sections 200 (d) and 213 (a).) For instance, in any case in which it is necessary to use an inventory, no accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See articles 51 and 52.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see article 1615.)

The true income, computed under the Revenue Act of 1926 and, where the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return. If for any reason the basis of reporting income subject to tax is changed, the taxpayer shall attach to his return a separate statement setting forth for the taxable year and for the preceding year the classes of items differently treated under the two systems, specifying in particular all amounts duplicated or entirely omitted as the result of such change.

A taxpayer who changes the method of accounting employed in keeping his books for the taxable year 1925 or thereafter

should, before computing his income upon such new basis for purposes of taxation, secure the consent of the Commissioner. Application for permission to change the basis of the return shall be made at least 30 days before the close of the period to be covered by the return and shall be accompanied by a statement specifying the classes of items differently treated under the two systems and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change.

* * * * *

ART. 24. *Methods of accounting.*—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. (See section 1102 and article 1321.) Among the essentials are the following:

* * * * *

(3) In any case in which the cost of capital assets is being recovered through deductions for wear and tear, depletion, or obsolescence any expenditure (other than ordinary repairs) made to restore the property or prolong its useful life should be added to the property account or charged against the appropriate reserve and not to current expenses.

ART. 161. *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business may be deducted from gross income. For convenience such an

allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the property in the business, equal the basis of the property determined in accordance with section 204 and articles 1591–1603. Due regard must also be given to expenditures for current upkeep. * * *

ART. 165. [As amended by T. D. 4422, XIII–1 Cum. Bull. 58.] *Method of computing depreciation allowance.*—The capital sum to be recovered shall be charged off over the useful life of the property, either in equal annual installments or in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production. Whatever plan or method of apportionment is adopted must be reasonable and must have due regard to operating conditions during the taxable period. The reasonableness of any claim for depreciation shall be determined upon the conditions known to exist at the end of the period for which the return is made. Where the cost or other basis of the property has been recovered through depreciation or other allowances no further deduction for depreciation shall be allowed. The deduction for depreciation in respect of any depreciable property for any taxable year shall be

limited to such ratable amount as may reasonably be considered necessary to recover during the remaining useful life of the property the unrecovered cost or other basis. The burden of proof will rest upon the taxpayer to sustain the deduction claimed. Therefore, taxpayers must furnish full and complete information with respect to the cost or other basis of the assets in respect of which depreciation is claimed, their age, condition and remaining useful life, the portion of their cost or other basis which has been recovered through depreciation allowances for prior taxable years, and such other information as the Commissioner may require in substantiation of the deduction claimed.

ART. 166. *Obsolescence.*—With respect to physical property the whole or any portion of which is clearly shown by the taxpayer as being affected by economic conditions that will result in its being abandoned at a future date prior to the end of its normal useful life, so that depreciation deductions alone are insufficient to return the cost (or other basis) at the end of its economic term of usefulness, a reasonable deduction for obsolescence, in addition to depreciation, may be allowed in accordance with the facts obtaining with respect to each item of property concerning which a claim for obsolescence is made. No deduction for obsolescence will be permitted merely because, in the opinion of a taxpayer, the property *may* become obsolete at some later date. This allowance will be confined to such portion of the property on which obsolescence is definitely shown to be sustained and cannot be held applicable to an entire property unless all portions thereof are affected by the con-

ditions to which obsolescence is found to be due.

ART. 169. *Charging off depreciation.*—A depreciation allowance, in order to constitute an allowable deduction from gross income, must be charged off. The particular manner in which it shall be charged off is not material, except that the amount measuring a reasonable allowance for depreciation must be either deducted directly from the book value of the assets or preferably credited to a depreciation reserve account, which must be reflected in the annual balance sheet. The allowances should be computed and charged off with express reference to specific items, units, or groups of property, each item or unit being considered separately or specifically included in a group with others to which the same factors apply. The taxpayer should keep such records as to each item or unit of depreciable property as will permit the ready verification of the factors used in computing the allowance for each year for each item, unit, or group.

(The corresponding articles of Regulations 74, promulgated under the Revenue Act of 1928, are to the same effect.)

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